

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR: [REDACTED]: Postf-152346-01
[REDACTED]

date: JAN - 2 2002

to: [REDACTED], LMSB Team Manager.
Stop: 4201 [REDACTED], Group [REDACTED]

from: Associate Area Counsel, [REDACTED] LMSB Area [REDACTED]
(Natural Resources)

subject: [REDACTED] Corporation
Computation of ITC Carry Over

This memorandum is in response to your request for advice concerning the computation of ITC carry over when non-transition property has been recharacterized as transition property.

ISSUES

A. Whether the taxpayer must adjust the basis of property which was placed in service during the years [REDACTED] through [REDACTED] for the year it was placed in service pursuant to I.R.C. § 49(d)(1) when:

1. In the year the property was placed in service, the property was treated as non-transition property under section 203(b)(1) of the Tax Reform Act of 1986 (i.e. the ITC was not claimed and the property depreciated under MACRS).

2. The property qualifies as transition property pursuant to section 203(b)(1) of the Tax Reform Act of 1986 (i.e. the ITC is allowable and the property is depreciated under ACRS).

3. All ITC generated during the years [REDACTED] through [REDACTED] may be carried forward to the year [REDACTED], which year is open by agreement.

4. The taxpayer adjusts its ITC carry over to the year [REDACTED] to include ITC on the property.

5. The taxpayer has not received the permission of the Service to change its method of accounting with respect to the property.

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B. If the taxpayer is required to adjust the basis of the property in the year it was placed in service due to the allowance of the ITC, should the recomputation of depreciation expense, for purposes of determining the correct amount of ITC carry over, be made pursuant to the MACRS depreciation system?

CONCLUSION

If the taxpayer recomputes its ITC carry over to include the amount of ITC allowable with respect to the recharacterized property, then the taxpayer must adjust the basis of property in the year the property is placed in service under I.R.C. § 48(q).

For purposes of determining the amount of ITC carryover, depreciation expense should be computed under the ACRS depreciation system with a reduction in basis as required by I.R.C. §§ 49(d)(1)(A) and 48(q)(1) because it is necessary to redetermine the correct tax liability for each year the ITC could have been used.

FACTS

General Background

[REDACTED] Corporation ([REDACTED]) is a holding company which files a consolidated income tax return. [REDACTED] is a first tier subsidiary of [REDACTED] and accounts for approximately [REDACTED]% of the revenues and assets of [REDACTED]. [REDACTED] owns [REDACTED]% of the outstanding shares of common stock of [REDACTED]. The issue in this case relates solely to [REDACTED].

[REDACTED] is a public utility subject to regulation by the [REDACTED] and the Federal Energy Regulatory Commission. [REDACTED] is primarily engaged in the production, purchase, transmission, distribution, and sale of electricity. [REDACTED] is the [REDACTED] electric utility in [REDACTED] providing electric power to the [REDACTED] of the state, including the city of [REDACTED].

Based on a review of ITC claimed in the years [REDACTED] through [REDACTED], [REDACTED] determined that ITC had not been claimed on many properties which qualified as "transition property." [REDACTED] contends that qualifying property in the amount of about \$[REDACTED] had not been included in the ITC computations for those years. As a result, [REDACTED] concluded additional ITC in the amount of \$[REDACTED] was available in the year [REDACTED] and an informal claim for the additional ITC was filed on [REDACTED].

After the Service had examined the evidence presented by [REDACTED], the parties agreed to correct certain duplications, computational mistakes, mis-classifications, and other errors. As a result, the revised claim is for additional ITC in the amount of \$ [REDACTED], based on property with a basis of \$ [REDACTED].

The Service agrees that certain of the properties which were not reported as transition property are, in fact, qualifying transition properties. It is these properties that are of concern in the issue presented. Further, the taxpayer has incurred net operating losses which cause the benefit of any ITC generated in the years [REDACTED] through [REDACTED] to be carried over to the year [REDACTED].

Change in Accounting Method

[REDACTED] reviewed all of the property placed in service during the years [REDACTED] through [REDACTED]. [REDACTED] determined, and the Service agrees, that it treated certain section 38 property which qualified as transition property as non-transition property. The taxpayer is now recharacterizing the non-transition property as transition property. As a result, property which was MACRS property will be recharacterized as ACRS property and, therefore, be eligible for ITC.

[REDACTED] has not and does not propose to amend its returns for the years [REDACTED] through [REDACTED]. [REDACTED] filed a Form 3115 effective for the year [REDACTED] proposing to change its method of accounting for five categories of property, including a category for transition property. [REDACTED] proposed that the ACRS depreciation system be utilized for transition property commencing with the tax year [REDACTED]. The property had been reported under the MACRS depreciation system. [REDACTED] initially considered the change in methods to fall within the automatic consent procedures of Rev. Proc. 98-60, 1998-2 C.B. 759 but subsequently conceded that it did not.

On [REDACTED], [REDACTED] filed a new Form 3115 for the transition property which was to be effective for the year [REDACTED]. However, to be effective, the Commissioner must concur with the change in accounting method. See Rev. Proc. 97-27, 1997-1 C.B. 681. The Commissioner denied the request due to the Service's ongoing examination, but would permit reapplication if the change was not made on examination.

Statute of Limitations

The statute of limitations for the year [REDACTED] has been extended, and is currently open by execution of Form 872. Furthermore, the taxpayer has incurred net operating losses such that the benefit of any additional ITC will properly be carried over until the year [REDACTED].

PROPOSED POSITION

Section 201 of the Tax Reform Act of 1986 amended the depreciation provisions of I.R.C. § 168, eliminating the use of the ACRS depreciation system for property placed in service after December 31, 1986. Property placed in service after that date is subject to the MACRS depreciation system. The Act, however, provided transitional rules exempting certain property or transactions from such amendments. Section 211 of the Act repealed the investment tax credit for any property placed in service after December 31, 1985, but provided (in paragraphs (b) and (e) of I.R.C. § 49, as in effect prior to the enactment of the Revenue Reconciliation Act of 1990) that such repeal shall not apply to "transition property"¹ to which the amendments made by section 201 of the Act do not apply.

Certain section 38 property of the taxpayer which qualified as transition property was originally treated as non-transition property on the taxpayer's returns for the years [REDACTED] though [REDACTED]. Thus, although the taxpayer could have claimed the ITC on the property, it did not. The taxpayer proposes to correct the amount of ITC carried over to the year [REDACTED] by claiming the ITC on the property which otherwise qualified as transition property and recomputing the ITC carryover. ITC on qualified section 38 property need not have been claimed on an income tax return, or in a timely claim for refund for the year the property was placed in service, before the credit can be carried over under section 46(b) to an open year. See Rev. Rul. 82-49, 1982-1 C.B. 5.

¹ For transition property, ITC was phased out over a number of years. Transition property placed in service in 1986 received the full 10% credit; property placed in service in 1987 received a reduced credit of 8.25%; and property placed in service thereafter received a credit of only 6.5%. I.R.C. § 49(b) and (c). The reduction also applies to credits that are carried forward. Rev. Rul. 87-113, 1987-2 C.B. 33.

Accordingly, assuming that the assertion that the taxpayer has available ITC which can be carried over is accurate,² the taxpayer can correct the ITC carried over to the year [REDACTED].

For depreciation purposes, the taxpayer proposes, in the year [REDACTED], to recharacterize certain depreciable property as transition property thereby resulting in the taxpayer changing its method of accounting for depreciation of such property.³

² Section 196(a) provides that, if any portion of the qualified business credit determined for any tax year has not, after the application of section 38(c), been allowed to the taxpayer as a credit under section 38 for any tax year, an amount equal to the unused credit is allowed as a deduction for the taxpayer for the first tax year following the last tax year for which the unused credit could have been allowed under section 39.

Section 221(a) of the 1986 Tax Reform Act, 1986-3 (Vol. 1) 90, reduced the general business credit limitation in section 38(c) to \$25,000 plus, 75 percent of taxpayer's net tax liability that exceeded \$25,000. Pursuant to section 221(b) of the 1986 Act, this reduction in the general business credit percentage limitation was effective for taxable years beginning after December 31, 1985.

³ Under I.R.C. section 446(e), a taxpayer may not change "the method of accounting on the basis of which he regularly computes his income in keeping his books" without first obtaining the Secretary's consent. The applicable regulations define "method of accounting" operationally. It includes both the "overall method of accounting" that a taxpayer uses and "the accounting treatment of any item." Treas. Reg. § 1.446-1(a)(1). Thus, a taxpayer changes its method of accounting when it changes either the "overall plan of accounting for gross income or deductions or . . . the treatment of any material item used in such overall plan." Treas. Reg. § 1.446-1(e)(2)(ii)(a). Conversely, a change in method of accounting does not include correction of mathematical or posting errors, nor does it include "adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction." Treas. Reg. § 1.446-1(e)(2)(ii)(b).

Here, in the year [REDACTED], the taxpayer proposes to recharacterize certain depreciable property as "transition property" pursuant to section 203(b)(1) of the Tax Reform Act of 1986. As a result, the taxpayer proposes to change its method of computing depreciation for this property from MACRS to ACRS.

I.R.C. § 446(e) and Treas. Reg. § 1.446-1(e) provide that, in general, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. In limited circumstances, the Commissioner's consent to change accounting methods is automatic.

Here, the taxpayer would be required to obtain the Commissioner's consent to change its method of accounting. A taxpayer's change from the MACRS depreciation system to the ACRS depreciation system for any property subject to the transition rules in section 203(b) or 204(a) of the Tax Reform Act of 1986 is not a change for which the Commissioner's consent will be given automatically. Rev. Proc. 99-49, 1999-2 C.B. 725, Appendix § 2.01(2)(b)(xiv); Rev. Proc. 98-60, 1998-2 C.B. 761, Appendix § 2.01(2)(b)(xiv).

On the other hand, the correction of the ITC carry over is not a change in accounting method. A change in a method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). See Treas. Reg. § 1.446-1(e)(2)(ii)(b). Moreover, the increase in the ITC, here, permanently affects the taxpayer's income. Generally, ITC affects tax liability and not income. Here, however, the increase in the ITC reduces the depreciable basis of the taxpayer's transition property at issue thereby resulting in a decrease in the amount of depreciation allowable. See sections 49(d)(1)(A) and 48(q)(1). Because the taxpayer has not yet disposed of the transition property and it has been more than 5 years since the property was placed in service by the taxpayer, this reduction in basis is not recovered by the taxpayer at a later time (for example, through depreciation or upon disposition of the property). See sections 47(a)(5) and 48(q)(2). Consequently, the increase in the ITC and the change in the ITC carryover, here, does not involve the timing of deductions and, thus, is not a change in method of accounting.

Because this change in depreciation involves the timing of deductions, the taxpayer's proposed change is a change in the treatment of a material item. Accordingly, the taxpayer's proposed change in computing depreciation for the transition property at issue from MACRS to ACRS constitutes a change in accounting method.

If the ITC is allowed under section 46(a), section 48(q)(1) requires taxpayers to reduce the basis of the section 38 property by 50 percent of the investment credit determined with respect thereto. Under section 49(d)(1)(A), for property placed in service after December 31, 1985, section 48(q)(1) shall be applied with respect to transition property by substituting "100 percent" for "50 percent." Section 49(d)(1)(B) also provides that section 48(q) shall be applied without regard to section 48(q)(4), which provides for the election of reduced credit in lieu of making a basis adjustment.

The basis adjustment under sections 49(d)(1)(A) and 48(q)(1) is made in the year the property is placed in service. This is so, even though the ITC is carried over and is reduced under section 49(c)(2). B.F. Goodrich v. United States, 94 F.3d 1545 (Fed. Cir. 1996) (Basis is reduced by the amount of credit for which the property is eligible. When property is placed in service, it is eligible for the credit irrespective of whether the credit later may be carried forward and reduced.); Rev. Rul. 87-113, 1987-2 C.B. 33.

Taxpayer's claim for additional ITC will require a determination of the proper carry over of ITC to [REDACTED]. In order to determine the proper amount of ITC that taxpayer could carry over, the taxpayer's entire tax liability must be redetermined for the years that the credits could have been used. This redetermination must include items for which the statute of limitations would bar assessment of additional tax, and include adjustments that decrease the tax as well as those that increase the tax. This redetermination is supported by, Lewis v. Reynolds, 284 U.S. 281 (1932), XI-1 C.B. 130, aff'g 48 F.2d 515 (10th Cir. 1931), X-1 C.B. 180. (in determining whether a taxpayer had overpaid tax, it is proper for the Service to redetermine the taxpayer's entire tax liability even though the applicable statute of limitations bars the assessment and collection of any additional tax); Clayton v. Commissioner, T.C. Memo. 1997-327, aff'd without published opinion, 181 F.3d 79 (1st Cir. 1998) (claimants may recover on their claim only to the extent to which they would be entitled to a refund if their tax liability were properly calculated without regard to the statute of limitations); Rev. Rul. 81-87, 1981-1 C.B. 580 (holding that all adjustments that increase or decrease taxable income, even those barred by the statute of limitations, must be taken into account in determining the amount of an overpayment of tax).

Taxpayer has recharacterized certain property as transition property. In computing tax liability for years in which transition property is a factor, the basis in the transition

property is adjusted under sections 49(d)(1)(A) and 48(q)(1), and the remaining basis is recoverable through depreciation deductions determinable under ACRS.

Accordingly, in determining the correct amount of ITC carried over to the year [REDACTED], the basis of the transition properties must be adjusted in the years the transition properties are placed in service as required by sections 49(d)(1)(A) and 48(q)(1), and the ACRS system of depreciation must be utilized in determining the proper depreciation deductions for the transition properties.

We consider the statements of law expressed in this memorandum to be significant large case advice. Therefore, we request that you refrain from acting on this memorandum for ten (10) working days to allow the Division Counsel, (Large and Mid-Size Business) an opportunity to comment.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions or require additional information, please contact me at [REDACTED].

[REDACTED]
Associate Area Counsel
(Large and Mid-Size Business)

By: [REDACTED]

Attorney